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Introduction

Chairman Baker, Vice Chairman Ryun, and Ranking Member Kanjorski, thank you for the opportunity to participate in today's hearing on ways to preserve the competitive position of the U.S. capital markets.

As you know, I am here as the Chief Executive Officer of the Financial Services Forum. The Forum is a financial and economic policy organization comprising the chief executive officers of 20 of the largest and most diversified financial institutions with operations in the United States. The Forum works to promote policies that enhance savings and investment, and that ensure an open, competitive and sound global financial services marketplace. As a group, the Forum's member institutions employ more than 1.5 million people in 165 nations, and hold combined assets of more than $12 trillion.

Today's hearing is both important and timely. America stands at a critical crossroads in our history as a nation. Faced with the twin realities of globalization and international competition, will the United States retreat behind a wall of self-delusion and the false protections of tariffs and trade barriers, pretending that the world hasn't changed, fundamentally and permanently? Or will the United States embrace and meet the challenges of competition – to the betterment of all Americans and the world?

By calling this hearing today, Mr. Chairman, you have signaled that you understand that America must not turn inward. The financial services industry thanks you for your vision and your leadership. Not only would such a course be very damaging to the U.S. economy, the world at this critical juncture in history continues to need the United States to lead by example.

Preserving the Strength and Vitality of the U.S. Economy

Mr. Chairman, you are correct when you say that being the world's premier capital market is not our birth right. We earned that distinction by working hard to make the United States the marketplace of choice. In that regard, I think it's important to emphasize that any effort to preserve the international competitiveness of the U.S. capital markets must begin with preserving the strength and vitality of the U.S. economy more broadly. In many ways, our world-class capital marketplace is both a source of tremendous strength for, and a reflection of, our enormously productive, complex, and dynamic U.S. economy.

With that in mind, I'd like to share with you some new information that I'm sure you'll find of interest. The 20 member CEOs of the Financial Services Forum meet twice a year, our most recent meeting occurring earlier this month. At that meeting, for the first time, we conducted a survey of our members regarding their outlook on the U.S. and global economies.

The answers we collected are of particular value because our members are the CEOs of the largest financial institutions. As you know, Mr. Chairman, the financial sector is unique in that it is the enabling sector of our economy, fueling the activities and risk-taking of every other sector. Our members make decisions every day about which ventures to finance and where to put their capital at risk, both here in the United States and around the world. In that way, they have a unique vantage point – a "commanding heights" perspective – on the U.S. and global economies. I've attached the full results of our survey to my written testimony for the record.

As part of the survey, we asked our CEOs to rate in order of seriousness a dozen potential threats to the global economy. The top three threats – rated far more serious than other selections – were: 1) energy prices, 2) terrorism, and 3) anti-globalization and protectionism.

We then asked the same question about potential threats to the U.S. economy. The four most serious threats, according to our CEOs, were: 1) energy prices, 2) rising healthcare costs, 3) terrorism, and 4) the U.S. government's unfunded entitlement liabilities. Rated closely behind were complex regulations and frivolous litigation.

In our final question, we asked the CEOs: "On a scale of 1 to 5 (with 1 being 'not important' and 5 being 'the most important') please rate the following potential actions taken by Congress to reflect their importance to making the United States more competitive in the global economy." Our CEOs gave each of the following Congressional priorities a better-than-3 rating, again with 5 being "the most important":

- Promote free trade;
- Improve U.S. education;
- Address unfunded entitlement liabilities;
- Address litigation reform;
- Extend the tax cuts on capital gains and dividends; and,
- Address general tax reform.

Clearly, our financial sector leaders believe that Congress has much important work to do to keep the United States competitive in an increasingly global economy.

The Unique Role and Strength of the U.S. Capital Market

Let me turn now the specific topic of keeping our capital market competitive.

Capital is the lifeblood of any economy's strength and well-being. Investment capital enables the research and risk-taking that fuels competition, innovation, productivity, and prosperity. Successfully competing for global capital, therefore, will always be a national priority – which is why a strong, dynamic, and competitive capital marketplace is so important.

At present, the U.S. capital market is the largest in the world, accounting for 45 percent of global equities and more than half of world's corporate debt securities. The U.S. market is also the deepest, most sophisticated, most efficient, and most stable capital market in the world.

These aspects of the U.S. market provide substantial benefits for issuers of securities and investors alike. For investors, benefits include a wider range of investment alternatives, highly efficient pricing, and greater liquidity. For issuers of securities, benefits include a cheaper cost of capital, an increased shareholder base, and enhanced corporate prestige.

For foreign firms that list on U.S. stock exchanges, these benefits translate into a so-called "listing premium." Academic studies have consistently shown that foreign firms listed in the United States have a higher valuation than foreign firms listed elsewhere. Indeed, a study released by Ohio State University in the fall of last year concluded that cross-listed foreign firms enjoy a valuation premium of 14 percent on average, and as high as 31 percent.[1]

Having the world's premier capital market within our borders has conferred many benefits and advantages to the United States. It is no coincidence that the world's largest, most liquid, and competitive capital market is part of the world's largest, most productive and innovative economy.

Critical Importance of Investor Confidence

Mr. Chairman, the foundation of any competitive capital market is investor confidence. When investors put their hard-earned capital at risk, by purchasing shares in a company or its debt securities, they must have faith that the company is telling the truth about its business and its finances. They must be sure that the company's financial statements have been prepared using high-quality accounting standards designed to accurately reflect the company's financial condition.

If investors don't have that faith – or if their faith is ever undermined – investors will insist on a risk premium on their investment. The net effect of this "uncertainty" or "anxiety" premium is to raise the cost of capital, with clearly negative implications for business investment, risk-taking, innovation, productivity, and, therefore, job creation.

[1] Study by Andrew Karolyi, Professor of Finance, Ohio State University.

As it becomes more difficult, more expensive, and more time-consuming to distinguish the good from the bad, investors might well abandon questionable markets for others around the world. Even worse, they may choose not to invest at all.

This scenario is of particular concern at a time when more than half of U.S. households own equities, and when investment decisions regarding the deployment of retirement funds are increasingly being delegated to the individual beneficiaries. The number of America shareholders has risen from 30 million in 1980 to more than 84 million in 2002. And those individual investors – putting money into 401(k) pensions, mutual funds, and brokerage accounts – account for up to 80 percent of the new money flowing into U.S. stock markets.

Since the 1930s, the United States has required some of the most extensive financial disclosures, backed up by one of the most robust enforcement regimes in the world. Companies wishing to list on U.S. exchanges must register with the SEC, which regulates listed companies to protect investors and creditors. The SEC requires companies to produce financial statements that demonstrate their financial status. Theses statements must meet standards established in US GAAP (Generally Accepted Accounting Principles). Independent auditors must audit companies' financial statements to attest to their validity and compliance with GAAP.

Such requirements entail substantial costs, particularly for foreign firms who must reconcile their financial statements to U.S. standards. But such costs are more than offset by the reduced cost of capital, the prestige, and other benefits that come with listing in the United States.

Educated investors understand that investing by its very nature entails risk, but the U.S. government has built a rigorous framework of investor protections to ensure an open, fair, and transparent marketplace, and a level playing field for all investors, large or small. And the results are clear – nearly half of all equity shares in the world, by market capitalization, trade in the United States, and foreign investors have entrusted more than $4.5 trillion to our equity markets.

Late '90s Scandals Undermine Investor Confidence

Unfortunately, in the boom years of the late 1990s, with equity prices climbing ever higher, new companies in a mad rush to go public, and the markets under the spell of what Alan Greenspan famously called "irrational exuberance," too many forgot the critical importance of maintaining the confidence and trust of investors.

As the dot.com bubble burst, a parade of corporate scandals began. Enron, WorldCom, Adelphia, Health South, Tyco, Global Crossing, Cedant, and others were accused of managerial fraud, accounting irregularities and other governance abuses. While the vast majority of corporate officers are honest people who discharge their responsibilities with the highest ethical standards, it became apparent that an erosion of general standards had occurred, with questionable practices becoming accepted by too many and ethical corners too often being cut.

The unfortunate effect of this deterioration in corporate governance was to undermine investors' faith in the integrity and basic fairness of the world's greatest capital market. The subsequent drop in equity prices and the reluctance of investors to return to the markets once prices stabilized led to the loss of more than $7 trillion of equity value – nearly half of the markets' total capitalization.

Sarbanes-Oxley

The government's response came in 2002 when Congress passed and President Bush signed into law the Sarbanes-Oxley Act – the most significant piece of securities legislation passed since the Securities Acts of 1933 and 1934, the latter of which created the Securities and Exchange Commission.

Sarbanes-Oxley created the Public Company Accounting Oversight Board to oversee the audit profession, and created new rules to protect auditor independence. It addressed conflicts of interest faced by securities analysts, increased the penalties for financial fraud, and gave the SEC additional resources. The Act also instituted other important safeguards, such as requiring the chief executive and chief financial officers of issuing companies to personally certify the company's financial statements, and mandated that auditors certify the adequacy of the issuer's internal controls – the so-called Section 404 provision of the statute.

As you know, Mr. Chairman, in the nearly 4 years since its passage, Sarbanes-Oxley has become a topic of spirited debate. Some observers argue that the Act went too far, imposing heavy compliance and legal burdens, especially on smaller businesses, and that Congress should take corrective action. Others argue that any roll-back of Sarbanes-Oxley would damage the critically important investor confidence the Act was intended to shore up.

In assessing the effect of Sarbanes-Oxley, we first must acknowledge what has happened since its passage. Investors – including millions of individual investors – have returned to the markets, pushing the Nasdaq, the S&P 500 Index, and Dow Jones Industrial Average to 5-year highs and creating more than $5 trillion in additional equity value.

Now, it's important to remember that association does not necessarily imply causation. Indeed, another major event that occurred not long after the passage of Sarbanes-Oxley that also boosted investor confidence was the reduction in tax rates on capital gains and dividends. Such cuts have powered equity markets by rewarding risk-taking and encouraging the flow of new capital into the markets. Congress must not allow these cuts to expire.

Having said that, it's my view that one cannot credibly argue that the confidence-boosting aspects of Sarbanes-Oxley have had nothing to do with the impressive performance of U.S. equity markets since 2002.

At the same time, however, other developments have established a pattern that should be deeply concerning to all of us:

- In 2005, the United States accounted for 20 percent of worldwide IPO proceeds, down from 35 percent in 2001.

- In 2005, 23 of the 25 largest IPOs did <u>not</u> list in the United States.

- In 2005, the top 10 IPOs, measured by global market cap, were <u>not</u> registered in the United States.

- In 2005, the largest IPO in five years listed in Hong Kong.

- In 2000, nine out of every 10 dollars raised by foreign companies through new stock offerings were raised in the United States. In 2005, the reverse was true – nine out of every 10 dollars raised by foreign companies through new company listings occurred <u>outside</u> the Unites States, principally in Europe.

- In 2005, 41 start-ups backed by venture-capital investors went public, down from 67 in 2004 and 250 in 1999.

- A recent London Stock Exchange survey of 80 international companies that went public on its market found that of those that contemplated a U.S. listing, 90 percent decided that Sarbanes-Oxley made London more attractive.

- In an attempt to capitalize on the reluctance of foreign firms to list in the United States, the LSE has launched promotional initiatives to give companies more listing options, including a special listing discount for smaller companies.

- Korean retailer Lotte Shopping recently conducted the largest IPO in Korean history, choosing to list its shares in Seoul and London.

- In February, I met with Charlie McCreevy, Commissioner of the European Union for the Internal Market. While in Washington, Mr. McCreevy was also scheduled to meet with SEC Chairman Cox, with whom he wanted to talk about easing U.S. requirements for foreign companies to *de*-list from U.S. exchanges.

Our public company corporate governance standards are not uniquely responsible for this troubling trend. Other contributing factors surely include the rising costs associated with frivolous litigation, rising healthcare costs in the United States, and the costs associated with foreign companies having to reconcile their financial statements to meet GAAP standards. But given the evidence, Mr. Chairman, it seems clear that, in addition to the acknowledged benefits of our corporate governance laws, unintended consequences have undermined the attractiveness of the U.S. capital market for many foreign companies.

On the topic of keeping our capital markets competitive, I would be remiss if I didn't point out that the apparatus of financial supervision in the United States is badly in need of reform. Our system remains a patchwork of legal entity-focused regulatory fiefdoms with overlapping jurisdictions, varying statutory responsibilities and powers and, too often, inconsistent supervisory postures and priorities. These circumstances have increasingly led to needless duplication, regulatory arbitrage, structural imbalances, inefficiency, and waste – with assuredly negative consequences for the competitiveness of our markets.

As Chairman Oxley has rightly observed: "The clear inefficiencies in the current system and the increasingly competitive nature of the international market are going to eventually collide and put U.S. financial services firms at a potentially serious disadvantage."

Supervisory and regulatory reform is a topic for another discussion – one which the Financial Services Forum has many ideas that we'd be delighted to share with this subcommittee.

Conclusion

Mr. Chairman, as we consider appropriate steps to take to preserve the current status of the U.S. capital market as the envy of the world, we cannot lose sight of the critical importance of investor confidence. Having the deepest, most liquid and stable market requires the capital that only investors can provide.

The overwhelming majority of investors – regardless of national origin or where they are placing their capital – want the same thing: honesty and integrity. They want to be sure that boards of directors take their fiduciary responsibilities seriously. They want to know that the financial information companies provide is authentic and reliable. They want to know that companies in which they invest have internal controls and governance standards adequate to properly and profitably manage their operations into the future. And when fraud is uncovered or securities laws are violated, investors rightly expect regulatory authorities to aggressively protect their interests through enforcement action.

We all want an equity listing in the United States to be what it has been for nearly 80 years – the global gold standard. We want listing and registration in the United States, with all its extensive requirements, to signal to issuers and investors alike that an issuing company is committed to, and has demonstrated its ability to meet, the highest standards of corporate governance and accountability.

But it is also true that successfully competing for scarce capital is becoming more difficult by the day. Simply stated, the United States is no longer the only game in town. Europe-based global exchanges such as the London Stock Exchange, the Deutsche Borse, and Euronext are well-capitalized, public, for-profit markets that are well positioned to aggressively compete for global market share. European-listed IPOs raised over $61 billion in 2005 – double the amount raised in 2004.

In Asia, the Tokyo, Hong Kong, Singapore, Seoul, and Malaysian markets continue to develop, and with the Chinese and Indian economies growing at 9 and 6 percent respectively, it's only a matter of time before the Shanghai and Bombay exchanges become formidable competitors.

Mr. Chairman, it is entirely in keeping with the principles of our corporate governance standards to re-evaluate whether the rules and regulations written to implement those principles are effective and appropriate:

- Do the rules and regulations achieve the intended objectives?

- Do they impose an unnecessarily high or costly burden on regulated firms, particularly smaller businesses?

- Do the costs of meeting the requirements outstrip the acknowledged benefits of listing in the U.S. markets?

- Are there steps that can be taken to alleviate some of the burden and costs without undermining investor confidence?

In other words, do our securities laws make it easier or harder to compete in the global marketplace? These are reasonable, prudent questions to ask. And preserving a strong and vital capital market is too important to the future of the United States not to ask them.

The United States has an historic opportunity to engage head-on the challenges of globalization and international competition, and thereby help create a more prosperous, peaceful, and democratic world. We can and must properly balance the twin priorities of defending the highest standards of corporate disclosure and accountability, while keeping the United States the world's capital market of choice.

Thank you very much for the opportunity to appear before the subcommittee.